Congressional Research Service

Congressional Research Service The Library of Congress Washington,
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Congressional Research Service Library of Congress May 22, 1995
Senate Committee on Affairs Subcommittee on Post Office and Civil Service

Good afternoon Mr. Chairman and members of the committee. My name is Carolyn Merck, and I am a Specialist in Social Legislation with the Congressional Research Service (CRS). I am pleased to have this opportunity to assist the committee in its review of the **Federal civil service retirement systems**. As you know, CRS is a nonpartisan organization. We advocate no position on issues before the Congress and make no recommendations. My statement this afternoon is intended to be factual and explanatory.

The witnesses from the General Accounting Office (GAO) have provided substantial background on the development, objectives, and design of the Federal retirement systems. I am going to focus my statement on the financing of the retirement programs, their costs, and the factors that influence costs.

FINANCING FEDERAL CIVIL SERVICE RETIREMENT

The Civil Service Retirement System (CSRS) and the pension component of the Federal Employees' Retirement System (FERS) are "defined benefit" plans. This means that retirement benefits to participants are determined by a formula, not an accumulating account balance. Although employees must pay into the systems throughout their years of Federal work, the amount of those payments is not a factor in the benefit formula and has no direct relationship to the amount of the pension. A worker's payments do not establish a right to any given level of benefits or to any post-retirement benefit increases. Congress can change the eligibility criteria, the benefit formula, or the provisions for post-retirement cost-of-living adjustments (COLAs) at any time, regardless of the amounts workers have paid. Although some have characterized the retirement plan for Federal workers as an implicit labor agreement between the Government as employer and Federalworkers, there is no legal contractual relationship. Rather, public retirement systems generally are considered entitlements granted by legislatures.

Like all other employer-provided defined benefits plans, the Federal civil service plans are financed mostly by the employer. The employer of Federal Government workers is the American taxpayer. Although public sector retirement systems customarily require employees to pay into the retirement system, the Bureau of Labor Statistics reports that in the private sector 97 percent of employees in medium and large firms are in pension plans fully financed by contributions from the employer. Nevertheless, under the CSRS, employee payments taken in from payroll withholding from *today's workers* (generally 7 percent of gross salary for those under CSRS), finance approximately 12 percent of the cost of benefits paid to *today's retirees.* FERS employee payments (0. 8 percent of pay) will finance a much smaller share of the outlays for retirees.

Looked at from the standpoint of the individual, the payments a career-long CSRS worker makes equal about 10 percent of the total lifetime annuity payments he or she will receive, although this proportion can vary substantially for different individuals. Under FERS, employee payments would be significantly lower as a proportion of the defined benefit pension.

Both the CSRS and the FERS pension plans are financed on a pay-as-you-go basis, as are the military retirement systems and social security. This means that, despite the existence of a trust fund, benefits to current retirees are paid from current revenues. Congress set up this system for the CSRS in 1920, and it has operated as pay-as-you-go system for the past 75 years. Moreover, this is the way benefits are and will be paid under the defined benefit pension component of FERS.

If the retirement systems are pay -as-you-go, what, then, is the role of the trust fund, and what are the issues pertaining to program liabilities?

Trust Fund Operations

The Nature of the Trust Fund

There is one civil service retirement trust fund that holds securities for both CSRS and FERS. A Federal trust fund is an account set up in the Department of the Treasury to which are credited Federal securities equal in value to the sums withheld from Federal employee paychecks, payments from the U.S. Postal Service for postal worker retirement, and certain other intergovernmental transfers required by law. The CSRS/FERS trust fund is not like private trust funds in that no money is actually deposited into it for investment outside the Treasury. Although the terms "payment" and "deposit" are often used to describe amounts credited to the fund, no payments are actually retained in the fund in the form of cash, and the trust fund is not a source of cash to the Government.

The credits in the trust fund are technically referred to as nonmarketable interest bearing securities of the U.S. Government. The securities are nonmarketable**. because they are not sold to the general public.** Every year securities are credited to the fund (about 464 billion in FY1994), and, as benefits are paid to retirees and survivors (about $64 billion in FY1994), securities recorded in the trust fund are reduced accordingly. The trust fund is actually an accounting ledger used to keep track of revenues earmarked for the retirement programs, benefits paid under those programs, and certain future benefit costs. The major purpose of the trust fund is to provide automatic budget authority for the payment of benefits up to the total value of the securities in the trust funds. Thus, the trust fund authorizes the Government to pay benefits without annual congressional appropriation - .The *cash* to pay current benefits and other costs come from general revenues and from mandatory contributions paid by and the U.S. Postal Service. Thus, in times of tight budgets, Congress often considers benefit cuts in order to reduce Federal spending or the deficit.

As of the start of FY1994, the civil service retirement trust fund held S312 billion in securities. This balance grew to about S340 billion by the start of FY1995, and will be an estimated S366 billion at the start of FY1996.

Annual Trust Fund Receipts and Disbursements

As 1 noted earlier, all receipts to the trust fund are in the form of Federal securities. In FY1994, the receipts to the fund totaled S63.5 billion, of which about $9.7 billion represented cash deposited in the Treasury, and S53.8 billion represented securities deposited as intragovernmental transfers. Disbursements totaled S36.4 billion. (See Table 1.)

Table 1. Receipts and Disbursements of the Civil Service Retirement And Disability Fund [FY1994

Total Fund Receipts	**$63.5 billion**
Receipts representing cash deposited in the general fund of the Treasury:	
Receipts representing cash from employees:	4.4 billion
U.S.P.S. payments (cash)	5.1
Miscellaneous	0.2
Receipts representing intragovermnental transfers:	
Agency matching. contributions	7.9
Payments required by P.L91-93	19.7
Miscellaneous	1.3
Interest on the balance of securities	24.8
Total Fund Disbursements: (liquidated securities to authorize Treasury disbursements):	**$36.4**
Payments to retirees	30.0
Payments to survivors	5.6
Lump sums (old law contribution withdrawals and payments to estates)	0.4
Refunds to resigning employees	0.3
Administrative costs and misc.	0.1

(Source: U.S. Budget Appendix for FY1996, p. 914)

The Trust Fund and the Budget

Cash Receipts

Although cash from employee payroll withholding and from the U.S. Postal Service is earmarked for Federal retirement, the trust fund has no way to receive or hold cash. All cash paid into the Government is deposited in the general receipt accounts of the U.S. Treasury and can be used for any purpose for which the

Government spends money, including paying current retiree annuities. It can also be used to reduce the deficit or Government borrowing, or to offset revenue losses that might be caused by a tax cut,

However, even though the cash is deposited in the Treasury, securities of equal value are credited to the trust fund to note that the Government had in fact received cash for the retirement system. Nevertheless, unlike social security, for example, the cash coming into the Treasury earmarked for Federal retirement ($9.7 billion in FY1994) is less than the annual cost of benefits ($36 billion in FY1994). Thus, there is no cash brought into the Treasury in excess of the amount needed to pay benefits on an annual basis.

Intergovernmental Transfers

When the Congress established the civil service retirement system in 1920, it set up the trust fund and called for employee and employer contributions. The employer contributions were to be made by employing agencies from appropriations made to them for that purpose. The agency payments were to match the amount of the contributions paid by employees. However, for many years, these agency payments were not made systematically, but it didn't matter because there were so few retirees that the cash from employees was enough to pay fully for the benefits to retirees without additional budget authority.

As the program matured it became necessary to establish a formal accounting system to take into consideration the effects of benefit obligations that had been incurred, but that had not been accounted for in the employee-employer matching scheme and those that would continue to result from coverage of new groups of workers and Federal pay raises (Federal pay raises increase the pre-retirement salary on which an annuity is based and therefore affect the cost of annuities). Thus, in P.L 91-93 in 1969, Congress established three types of credits that are added annually to the retirement fund in the form of Federal securities: (1) the amount necessary to amortize, over a Midyear period, any increase in the program's liability for benefits resulting from salary increases or coverage of new groups of employees; 2) the amount of the employer share of costs of benefits attributable to military service; and (3) interest, set at the fixed rate of 5 percent, on the estimated previously accrued or “static”. liabilities of the program for which no securities were credited to the fund, estimated to be S185.5 billion at the end of FY1993 (“static liability" meaning liabilities accrued up to the date of measurement, but excluding estimates for future pay raises, retiree COLAs, or changing interest rates).

Also in 1969, the CSRS employee payments were set at 7 percent of pay, which required an equal amount to be paid from funds appropriated to employing agencies. At that time, the “static” normal cost of the program was estimated to be 14 percent of payroll. (The “static normal cost”. is that percentage of every dollar of employee salary that should be set aside pay for the cost of benefits accrued up to the time of the estimate, but not including estimated future employee pay raises or retiree COLAs.) Thus, the static cost of the program was accounted for or “financed” through the combination of employee and agency payments, and the additional payments required by P.L 91-93 were to finance pay raises as they occurred (but not in advance) through the 30-year amortization payments. Thus, although there was .50-50. cost sharing for some of the system's costs, the Government assumed responsibility for other costs not included in the ongoing static normal cost measure.

The static normal cost is currently lower than 14 percent, although OPM has not recomputed it since 1969. It would be 9.5 percent if OPM's current interest rate assumption of 7.0 percent were used rather than the 5 percent used in 1969. (Using the 5-percent rate, the current static cost might be roughly 11 or 12 percent.) The Dynamic. normal cost of the CSRS (which includes estimated future pay raises, COLAS, and 7-percent interest) is currently 25.14 percent of payroll (including the employee share of 7 percent). Thus, the current 14 percent of CSRS pay that is credited to the fund from employee and agency payments “Overfunds” the CSRS according to the static funding measure set up in the 1969 law, but less than fully funds the system if the estimates include future pay raises, retiree COLAs, and current interest rates. Congress has not changed the 1969 law, and thus there is no requirement for the program to be funded according to dynamic cost estimates.

The three credits required by P.L. 91-93, plus agency matching payments, and interest on the balance of the fund, are all “intragovernmental transfers” that are received by the trust fund, and because the trust fund is an account within the Treasury, they do not constitute outlays from the Treasury and have no effect on the deficit.

Outlays

The only cost of the CSRS and FERS defined benefit retirement systems that are outlays from the budget and that contribute to the deficit are: (a) the cost of benefits to retirees and survivors; (b) payments to individuals who resign from the Government and withdraw their contributions (generally without interest); (c) repayment of employee contributions to the estates of deceased workers or retirees who have no survivors eligible for a survivor annuity; ;and (d) administrative costs. The cost of the programs and the need for general tax revenues to pay for Federal retirement has never, and will never, exceed the cost of these payments.

In FY1994, the total Federal outlays for these programs was $36.4 billion; the total cash received by the Treasury and earmarked for retirement was $9.7 billion; thus, the difference between these costs and receipts, $ 26.7 billion was the total cost of the system that was paid from general revenues without an offsetting earmarked receipt. In the analogy with the private sector, this would be the employer-paid share of the cost of the defined benefit pension plan for Federal employees.

PROGRAM LIABILITIES

The liabilities of a retirement system are the costs of benefits promised to workers and retirees. A retirement system is "fully funded" if a trust fund holds assets approximately equal to the present value of all benefits promised to retirees and vested employees (.vesting. in the Federal plans requires 5 years of employment covered by the system). Unfunded liabilities. are estimates of benefits for which assets have not been set aside in a retirement And and for which no future deposits are scheduled.

Total pension liabilities can be estimated using ~*dynamic.* assumptions which include estimated projected benefits including estimates of future pay raises and retiree COLAs, or using "static" assumptions, which account for pay levels and benefit accruals up to the date of the estimate, but excluding estimates of pension increases that might result from future pay raises or COLAs.

According to the Office of Personnel Management (OPM), at the end of FY1993, the estimated dynamic liability of the CSRS (net of future scheduled contributions) was $815 billion. The estimated dynamic future liability of FERS was $42.5 billion. Thus, total Federal liabilities for current and future retirees was $857.5 billion. (The FERS liability is smaller because it is a new system with comparatively few vested participants.)

Although CSRS and FERS use one trust fund, as of the end of FY1993, the securities deposited in it for CSRS totaled $276.7 billion. This fund balance can be characterized as "funded" liabilities of the CSRS and constituted about 34 percent of all estimated current and future liabilities. Securities deposited for FERS totaled $40.7 billion, which are the ~"funded". liabilities of that system. Thus, the total trust fund balance (total Funded liabilities.) was$S317.4 billion.

Congress designed the FERS defined benefit pension as a fully funded system. Thus, from the start, securities have been deposited in the trust fund equal to the full dynamic cost of that program As these estimated costs have changed since 1987 when FERS began, the amount of the securities deposited as the "Government's". share have been adjusted (no change is made to the employee share.) Consequently, there is no controversial issue regarding the funding status of FERS. Nevertheless, FERS benefits are and will be paid with cash from general revenues, authorized by the securities in the fund.

However, the unfunded liability of the CSRS, about $538.3 billion at the end of FY1993, is currently a controversial issue. But what do liabilities, funded or unfunded, really mean in terms of costs to the Government or taxpayers? The total liability of the CSRS (S815 billion) is the estimated amount the Government would have to pay all at one time if everyone who is or who ever has been a vested CSRS participant could demand a check for the present value of all the benefits to which they would be entitled from that time throughout their retirement until their death (or their survivor's death), taking into account estimated future pay raises they might receive (which affect the annuity at retirement) and retiree COLAs after retirement. *This event cannot happen in the Federal system.* Federal pension obligations cannot come due all at one time, unlike the situation that arises in the private sector when an employer goes out of business and must pay all promised pension obligations at once. Some of the Government's liabilities represent payments due to current retirees who receive their benefits one month at a time throughout retirement; others represent payments that will not commence for years to come because the workers are not yet eligible to retire. By the time they become eligible, others currently retired will have died. Thus, unlike private employers, the Government need not fully prefund the retirement system in order to insure against having to pay off all earned benefits simultaneously. It should be noted that the same reasoning applies to the social security system, which, throughout its 55 year history, has been largely pay-as-you go.

Nevertheless, there is no shortage of securities in the retirement trust fund to authorize benefit payments on an ongoing basis. For example, benefit payments totaled S36 billion in FY1994 when the trust fund balance was S317 billion, including S277 billion for CSRS, and OPM projections show trust fund balances continuing to grow.

THE FUTURE OF THE CSRS

Currently, about half of the Federal workforce is still covered by CSRS and about half is covered by FERS. Over the next two decades or so the number of CSRS workers will decline as they resign or retire, and the workforce will include mostly FERS participants. As the number of CSRS-covered workers declines, the assets credited to the trust fund for CSRS will decline, not because of loss of payroll contributions from workers, but primarily because the Government's payments will decline. Employee contributions "pay for". only about 12 percent of current annual benefit costs. However, the formulas by which the Government's

share of CSRS costs are determined are based on projections of long-term benefits; as long-terrn benefit projections decline in anticipation of the demise of the CSRS, the Government's funding will decline, although there will still be CSRS retirees and survivors entitled to benefits. According to OPM, CSRS benefit payments will begin to exceed the amount of assets credited annually to the trust fund for CSRS in about 2008, and the assets attributable to the CSRS will be depleted by about 2025.

When Members of Congress wrote the new FERS law in 1986, they understood that there would have to be a financial transition from CSRS to FERS in the next century, and they wrote the law to provide for that transition. First the law provides for one trust fund in which CSRS and FERS assets are combined**.** Therefore**,** *there is no separate CSRS trust fund that will be depleted.* Second, Congress established a system whereby benefit payments under the CSRS will be authorized by FERS trust fund securities as needed until there are no more CSRS benefits to be paid. Thus, the securities that are building up for FERS, and that are in excess of the amount needed to authorize FERS payments for some time, will be reduced each year by the amount by which CSRS benefits exceed CSRS assets. This will cause an increase in the FERS liability, but that liability will be Paid off. through a series of Midyear amortization payments. Using a 75-year projection period, OPM estimates that the total value of securities in the trust fund will grow throughout the projection period, ultimately reaching about 4.2 times payroll, or nearly 18 times the amount needed to pay annual benefits. This means that in the next century the trust fund will reach an ongoing steady state in which it will have a balance sufficient to *authorize* advance payment of 18 years of benefits.

In general, although OPM does not project the dynamic unfunded liability of the CSRS, that liability might increase slightly on a temporary basis early in the next century. However, it will have no economic effect, just as the current unfunded liability that accrued in the past has no current economic effect. The unfunded liability has no effect on the cost of the program, on the budget, on the deficit, or on taxpayers, either now or in the future. The only retirement system costs that affect current or future taxpayers are budget outlays for monthly benefit payments to retirees and survivors. The amount of those benefits are determined by formulas set in law by the Congress.

Although the total liability of the Federal pension plans, including the Funded amount (securities in the fund) and the unfunded amount, are irrelevant to the payment of benefits or the ”solvency”. of the programs, they do measure the projected, cumulative future cost of benefits, and some maintain that a reason to prefund plan liabilities is to ensure that taxpayers, who are the employers sponsoring these plans, know the magnitude of the commitment for future payments. Others say the Federal plans should be fully prefunded **because the** Federal Government requires private employers to prefund their plans, and they decry a double standard.

Others respond that although the unfunded liability of the Federal retirement system *per se* does not represent a risk to taxpayers, a fully funded program does not provide taxpayers or retirees with any particular protections either. The trust fund holds no cash and does not represent a source of cash from outside the Treasury. Even if the CSRS were fully funded, like FERS, the cash needed to write checks to retirees and survivors would be drawn from tax revenues.

PROGRAM COSTS

The cost of any defined benefit plan is a function of the size of the eligible population, the benefits for which they are eligible at the time of retirement as written in law, and postretirement COLAs. Thus, if Congress were to determine that the cost of the program is too high and should be reduced, there are a limited number of options for reducing the costs.

First, there is little that can be done to limit the number of retirees. All workers who vest in the system and who work long enough to qualify for a benefit are entitled to that benefit for as long as they live. One factor affecting program costs is the increasing longevity of the population. Increasing the earliest age at which CSRS and FERS workers may retire with unreduced benefits (currently age *55* for workers with at least 30 years of service) is sometimes suggested. However, the average age at which workers elect voluntary retirement is 61.5. Thus, raising the minimum age to 62, for example, saves little. However, a variation on this idea that is often used in the private sector is to allowed retirement before age 60 or 62, but pay less than the full accrued benefit. This is an option Congress wrote into the FERS plan to offer workers more flexibility in their retirement options.

Second, the factors in the benefit formula that influence the amount of benefits for which a retiree is eligible at the start of retirement are the *preretirement salary base* used in the formula and the *benefit accrual rate.* Currently, the salary base is the average annual pay of the employee's highest-paid 3 consecutive years (high-3). Before 1969, the salary base was the high-5 years. The longer the period included in the salary base, the lower the average preretirement pay on which the annuity is computed, assuming pay increases over time.

The accrual rate is the percentage of the preretirement salary base workers earn in pension benefits for each year of service. A high accrual rate yields a larger annuity than a lower rate. (Under the CSRS workers accrue benefits at 1.5 percent of high-3 for the first 5 years of service, 1.75 percent for years 6 through 10, and 2 percent for years over 10. Under FERS the accrual rate is 1 percent of high-3 for all years, or 1.1 percent for all years if the worker retires at age 62 or over.)

Thus, to reduce benefits at the start of retirement, the salary base could be lengthened, or the accrual rate could be reduced, or both.

COLAs are another factor influencing costs. Under CSRS all retirees receive COLAs annually equal to the rise in the Consumer Price Index (CPI). FERS retirees under age 62 receive no COLAs, and FERS COLAs may be limited to up to 1 percentage point less than the CPI if the CPI increase is over 2 percent.

Increasing employee contributions is another option, and is included in Title IV of H.R.1215, the Tax Fairness and Deficit Reduction Act (which passed the House of Representatives on April S. 1995). Increasing contributions shifts the costs of paying benefits to ***apparent retirees*** from the Government to *current workers,* and thus reduces outlays. However, it does not reduce the total cost of the benefits, that is, it addresses the cost issue on the Revenue side. but not on the Benefit side..

A final note about the future costs of the CSRS and FERS. The Congressional Budget Office (CBO) projects the cost of these programs as a percent of GDP to remain flat for a while and then decline in the next century. As CSRS phases out and FERS is the system under which most workers retire, the Government's cost for pension benefits under that program will be less than they are under the CSRS defined benefit plan because the FERS benefit formula is lower.

Although the nominal dollar cost of benefits will grow somewhat into the next century, most of the growth will be attributable to retiree COLAS, and some will be attributable to ongoing salary growth which is always passed through to the salary base **on which** benefits are determined. If benefit costs were computed in *constant dollars,* that is, removing the effects of inflation, there would probably be quite modest growth in program costs, since most of the growth would be attributable to wage growth in excess of inflation and to increasing longevity of retirees.

It is important to note that, in comparison with the social security program, *the retirement of the 'Baby boom' generation will have little effect on the Federal retirement programs.* Unlike social security, the size of the Federal retiree population is a function of the size of the Federal workforce, not the population as whole. Nevertheless, the Federal workforce is aging. This has occurred for a number of reasons, including hiring freezes over the past 15 years that have limited the number of younger workers hired who might otherwise create pressure for more turnover among older workers, and, some say, the design of the CSRS that prevents mid-career workers from leaving their Federal job because of lack of "portability". of the retirement benefits. About 50 percent of the current workforce will reach age 62 by the year 2111. Thus, there may be an increase in retirement rates early in the next century, but nothing like the magnitude of new retirees that will enter the social security system.

Thank you, and I will be glad to answer any questions.

Underlining by John de Matteo of Chapter 740